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May 23, 1997

RECEIVED

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
Building 85, Denver Federal Center
Denver, Colorado 80225

Subject: Notice of Proposed Rulemaking, 62 Fed. Reg. 3742 (January 24, 1997)

Dear Mr. Guzy:

Conoco Inc. ("Conoco") welcomes this opportunity to submit the enclosed comments to the Minerals Management Service ("MMS") with respect to the above-referenced notice of proposed rulemaking concerning the value of federal royalty on crude oil production.

Conoco is a wholly-owned subsidiary of E. I. DuPont de Nemours and Company. In 1996 its worldwide production of crude oil, condensate, and natural gas liquids averaged 378,000 barrels per day and its worldwide natural gas production averaged 1,285 million cubic feet per day. During the five-year period ending December 31, 1996, Conoco remitted royalty payments to the MMS in excess of $393 million.

Conoco further adopts by reference and hereby incorporates the comments filed on behalf of the American Petroleum Institute, the Independent Petroleum Association of America, and the Council of Petroleum Accountants Societies.

If you have any questions, please contact Mr. John Clark at (405) 767-5044.

Sincerely,

GC Rule

George C. Rule

Enclosure

cc: John Clark, Ponca City
Carol Harvey, Houston

MMS NOTICE OF PROPOSED RULEMAKING

INTRODUCTION.

On January 24, 1997, the Minerals Management Service published a Notice of Proposed Rulemaking on Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil ("MMS Notice") (62 F.R. 3742). The MMS Notice provided only a sixty (60) day public comment period. Subsequently, on February 18, 1997, the MMS officially extended the comment period through May 28, 1997.

Conoco is opposed to the proposed rulemaking in its entirety. Conoco believes that MMS' proposal to search for markets away from the lease is unnecessary, burdensome and contentious. When the MMS and other federal agencies market raw commodities belonging to the federal government, they normally market the commodity at the first practical market and do not create unnecessary, burdensome and contentious schemes to go beyond such a point based on a misinformed belief that a viable and competitive market does not exist at the point of production. The MMS should not go beyond the lease to establish market value except in extreme and rare circumstances.

MMS' proposal would further radically alter and unlawfully expand federal lessees' royalty obligations. The proper objectives which are listed below will not be met by MMS' proposed rule:

- The rule should effectuate the payment of royalty on the value of production at the well in its naturally occurring condition.

- The rule should provide certainty in royalty values. Lessees should know with certainty what they owe and have the ability to pay accurately and timely.

- The rule should be practical and capable of administration by the MMS in an efficient and cost-effective manner.

- The rule should be <u>practical</u> and capable of <u>compliance</u> by lessees in an <u>efficient</u> and <u>cost-effective manner</u>.

- The rule should be <u>capable of being applied to changing market conditions</u>.

- The rule should promote <u>simplicity</u>.

The impacts of the MMS proposal are unprecedented. Under the proposal, the vast majority of federal lessees, including even small companies who produce limited quantities of crude oil, will be thrown into the category of a "non arm's-length" seller of crude oil simply because they purchase one barrel of oil during a two year period. [It is a customary practice for lessees to purchase crude oil for use in normal wellhead and field operations.] Secondly, the proposal is a radical departure from both historic and current practice regarding the manner and method of determining royalty value at the well and for determining transportation costs which are deductible from royalty. Value for royalty purposes, which has historically been based on transactions <u>at the lease</u>, will be based on either the NYMEX "futures" price or an ANS "spot" price under the MMS proposal. Further, the Form 4415 proposed by the MMS is part of a completely new scheme for MMS to not only require extensive data which must be manually collected and submitted, but also requires analyzing the data to determine what amounts will be deductible as allowed costs. While the transportation number derived by the MMS will have a substantial impact on any company's total royalty obligation for each lease, there is nothing contained in the MMS proposal to describe MMS's methodology for determining the number or requisite procedural safeguards to ensure the number is fairly and accurately ascertained.

Based on the foregoing, Conoco is against MMS publishing an Interim Final Rule implementing the proposed rulemaking.

I. THE TRUE VALUE OF LEASE CRUDE OIL IS AT THE LEASE AND NOT SOME DISTANT TRADE CENTER.

Until MMS issued its proposed rule regarding how federal royalty oil would be valued in the future, the MMS correctly assumed that crude oil should be priced at the lease in all but rare instances. For well over 70 years there has been an active market for crude oil at the lease. This has been demonstrated over the years by the marketing of federal royalty oil under the benchmarks established in the 1988 federal regulations. Only as a last resort was the producer required to go off the lease to establish "market value" in valuing federal royalty crude oil. This has also been true for crude oil owned by other interest owners. The foundation for pricing crude oil at the lease for the past 70 years is the unassailable fact that numerous arm's-length transactions, representing significant quantities of crude oil, have occurred and continue to occur between sellers and buyers of crude oil at the lease who have opposing economic interests. In many instances the price basis was a price based on a particular company's posting. In some cases adjustments were taken for quality and transportation variances or other competitive factors. This market has always been and continues to be a very active, competitive market. The MMS does not have to go wandering away from the lease in an attempt to find a viable competitive market. The MMS' goal should be to fully participate in this representative lease market to value federal royalty oil.

Over the years the federal government has, at the direction of Congress, sold crude oil from the Naval Petroleum Reserves, Elk Hills, California. This sale of crude oil has not been done by looking to some reported price of Alaska North Slope crude oil or some reported Nymex futures price, but rather sales have been accomplished through a competitive bid process. Competitive bidding has also been used by the U.S. Forest Service to sell standing timber in the national forests. Likewise, the sale of crude oil from the Strategic Petroleum Reserve (SPR) has been accomplished through the bidding process. Bidding out raw commodities is superior to the proposed "netback" methodology being proposed by the MMS because it incorporates the economic decisions of competing and willing buyers and sellers at the lease. Significant market aspects that make the lease market different from trade center markets will be totally ignored by moving off the lease to determine crude oil value. The federal government has recognized this critical aspect of defining crude oil market value for years and the MMS should not abandon or ignore the importance and relevance of the lease market in valuing crude oil in the future.

Market value of lease crude oil must remain at the lease. Attempts to argue that crude oil can only be valued away from the lease is a non sequitur. The understanding, acceptance and wisdom of determining market value at the lease has been and continues to be demonstrated by a growing number of entities who actively market crude oil, some of whom are in the same position and hold similar royalty interests as the MMS, such as The University of Texas System and the Wyoming State Land and Farm Loan Office, State of Wyoming. These two entities are charged with seeking the best price for the crude oil they manage and in both cases they have recognized that the true value of lease crude oil is at the lease and have chosen to bid out crude oil at the lease to establish the fair market price.

Additionally, some members of the industry have begun to bid out crude oil for various reasons. In each case, to the extent possible, the point of bid and sale is at the lease. It is unnecessary, problematic and unfair to lessees for the MMS to determine lease crude oil value at some distant point off the lease.

II. THE MMS IS ATTEMPTING TO LIMIT THE DEFINITION OF "ARM'S-LENGTH TRANSACTION" WHICH, AS PROPOSED BY THE MMS, EFFECTIVELY PROHIBITS VALUING CRUDE OIL USING ARM'S-LENGTH TRANSACTIONS AT THE LEASE.

Under the proposed rulemaking Conoco, as well as almost everyone else that produces crude oil in the United States, would be prevented from using valid arm's-length transactions for the establishment of lease crude oil value. The MMS does not take the position that there are not valid arm's-length transactions at the lease, but rather, for some unknown reason, will discredit almost all such transactions as representing market value. In essence, such valid arm's-length transactions become non-arm's-length transactions exclusively by MMS's definition. Through this action the MMS ignores the vibrant, competitive market at the lease as described above. It would appear that through the regulatory process, the MMS is attempting to once again regulate the price of oil. President Ronald Reagan decontrolled the price of oil in January 1981, and the MMS should not disregard President Reagan's Executive Order through this rulemaking.

There is no justification for the MMS to ignore valid arm's-length transactions at the lease. It seems that, early in the rulemaking process, the MMS decided that they wanted to move downstream of the lease to establish crude oil value for federal royalty oil. However, they were burdened with the knowledge that there are valid arm's-length transactions that establish market value at the lease. Therefore, to make their scheme work, the MMS had to devise a method wherein they could ignore valid arm's-length transactions at the lease. They chose, through the use of definition, to limit the meaning of arm's-length transaction to effectively eliminate the concept for all intent and purposes at the lease. It is interesting to note that the MMS does not even attempt to ascertain if the Nymex or P-Plus markets, which they want to rely on to determine market value, represent valid arm's-length transaction information. They just assume this is the case.

III. THE MMS PROPOSED RULEMAKING WILL BE A SIGNIFICANT BURDEN ON THE PRODUCER AND PURCHASER OF FEDERAL ROYALTY OIL.

The MMS has a distorted notion that the burden on the industry to implement their new proposed rulemaking will not be exhaustive nor will require the addition of resources by lessees to be in compliance. The new Form MMS-4415 is reported to require only 15 minutes to fill out. The MMS also states that their "subject matter experts" estimate that, on average, only "64 exchange agreements and sales contracts" will need to be reviewed by a Payor to comply with these regulations. The MMS is obviously being misinformed by their "subject matter experts." Conoco has in excess of 900 contracts in force at any given point in time. Thousands of new contracts are written every year and under these new regulations Conoco would have to review each contract annually in an attempt to provide requested information, even those that do not have any connection to federal royalty oil. Therefore, thousands of MMS-4415 forms would be required of Conoco. These proposed rules would require that Conoco provide an MMS-4415 on an annual basis for "all your and your affiliates' crude oil production, and not just information related to federal lease production." We do not believe that MMS has the unlimited right to such information for lease properties that are not federal leases.

The MMS-4415 form itself is daunting. The form was constructed under the assumption that we have data related to the exchange parties' activities. It also assumes, incorrectly, that sulphur content is routinely determined <u>at the lease</u>.

We currently estimate that reviewing each contract to fill out MMS-4415 would take a minimum of **two (2) hours** per contract. Therefore, Conoco estimates that it will take 900 man-days (8-hour days) to accomplish the review of an entire year's contracts in order to fill out MMS Form 4415 properly. Squeezing this much work into a window of two months would require Conoco to assign 13 to 15 people full time to this task. Additionally, Conoco would be burdened with the time, cost and other resources necessary to train this 'army' of contract interpreters.

The MMS proposes that information from the MMS-4415's will be volume weight averaged each year and that the resultant number will be used for the ensuing year with no changes to reflect market changes. This application of a questionable number is absolutely unfair to the industry. Trade differentials fluctuate constantly. To mandate that the industry use an annualized number, representing a prior year, does not reflect current market conditions and thus places a significant economic risk on the lessee. In many instances the trader assessments are no more than a guess of market differences and therefore are unreliable and should not be used or relied upon in a way as proposed by the MMS. Trade assessments are 'indicators' not 'absolutes.' This is a major flaw of the MMS program. Additionally, the MMS proposes to use trade differentials reported in various trade publications such as Platt's Oilgram. This is also highly suspect and unfair to the industry because not all trade differentials reported in trade publications reflect actual market trade differences. For instance, the trade differential between Cushing and Guernsey may reflect 15¢ in favor of Cushing over a month's time because Platt's obtains assessments for each trading day. However, actual trades normally take place over only a 5 to 6 day trading window and the true differential may be in excess of 50¢ in favor of Cushing. Therefore, the monthly differential quoted in Platt's would not be representative of actual trades. Furthermore, Platt's reported trade differentials are often made up of trader's assessments and may not reflect actual transactions or they may represent only a small fraction of all the trades that take place.

IV. TRADE CENTER PRICES DO NOT REPRESENT LEASE MARKET CONDITIONS AND HAVE A UNIQUE PURPOSE THAT MAKES THEM INAPPROPRIATE FOR LEASE CRUDE OIL VALUATION.

The MMS has some knowledge of the fact that trade center spot prices overvalue base crude oil supplies for refiners. This experience comes from running the 20% Set Aside Program and the Small Refiner Bias Program. However, in both of these programs the MMS has not been necessarily interested in obtaining the highest price obtainable but rather in providing crude oil feedstocks to refiners who the federal government believed may be disenfranchised from access to federal royalty oil. The MMS is learning that as federal royalty crude oil prices go up, these select end users will be faced with economic decisions that may cause them to cancel their contracts with the MMS. Indeed, Sinclair Oil Corporation has given notice that they will terminate their taking of RIK barrels effective June 1, 1997. The MMS should expect others to follow.

The reason why small refiners will no longer purchase these barrels is that the Nymex crude oil price defined in the proposed rulemaking is a futures price for 'paper barrels.' Most domestic crude oil is marketed at prices below the Nymex reported prices. The Nymex is a totally different market than individual lease markets. The MMS cannot ignore this law of economics. Thousands of people who are unfamiliar with crude oil markets may participate in the futures market. In essence, they may take speculative positions wherein they are gambling that the price of crude oil will go one way or another. The absolute price and needs of the U.S. refining industry is foreign to their goals. It's true that on some days 50 to 60 million barrels or more of crude oil are traded on the Nymex, but very few of these paper barrels represent trades by refiners for refinery supply. It has been said that if the industry had to pay Nymex prices for all of their refinery crude oil supply, no refinery would survive. The cost would be just too exorbitant. In reality, most crude oil volumes purchased at major trade centers are to supplement base crude oil supplies purchased under long-term arrangements. If a refiner is short of crude oil supply in a given month, that refiner may decide to pay a premium to acquire incremental barrels to fill up the last few barrels per day of its intended refinery runs. Quite often this decision is based on incremental economics wherein the refiner judges the economics of the purchase of the higher priced barrel from the spot market against the incremental revenue from marketing an additional barrel of product. Since the fixed costs of the downstream infrastructure have not been included in the incremental economic decision, the refiner may have the flexibility to pay a higher price for a small quantity of a given month's feedstocks.

On the other hand, if a refiner ends up with too much supply, then it may choose to sell some in the spot market versus paying carrying costs to inventory surplus crude oil. The spot market is only a one-month market and generally represents the balancing of the industry's supply and demand for feedstocks for a given month. Obviously this is a totally different market than the market <u>at the lease</u> where the crude oil is produced.

During most of the 1990's, the U.S. downstream petroleum industry has made a profit of only about 65-85¢ per barrel (1 1/2¢ to 2¢ per gallon). This approximates a 7 percent return on investment. The industry stockholders recognize that they could get a higher return by investing money in bonds or possibly other money market accounts. Therefore, if the MMS mandates through their new proposed rulemaking that federal royalty crude oil will be valued based on spot market trade center prices the economics to the industry and return on investment will become even worse and may well result in some downstream businesses going out of business. The U.S. downstream petroleum business is in serious economic condition and is not reaping a windfall at the expense of royalty owners.

Likewise, purchasers of federal royalty oil, including resellers, who have invested in transportation infrastructure and marketing expertise would no longer be allowed a trading profit or transportation profit on federal royalty barrels under the MMS proposed rulemaking. Crude oil purchasers would have to evaluate their role in the business and may be forced to move on to other business endeavors which allow them to make a profit. If these people are driven out of the business by the MMS, who will be left to conduct the business of marketing crude oil off the lease? The MMS?

V. <u>THE MMS HAS ALWAYS HAD THE RIGHT UNDER THE TERMS OF THEIR LEASE AGREEMENTS TO TAKE THEIR ROYALTY OIL IN KIND AND MARKET IT</u>.

The MMS already has in place a remedy if they believe that their crude oil is being undervalued <u>at the lease</u>. They have always had the right in the lease agreements to take their oil in kind and market it themselves. Indeed, in some cases, they have done just that and are presently developing a plan to increase the scope of the RIK programs. Conoco, and most likely many others in the industry, would be willing to assist the MMS in such endeavors. Conoco believes that the MMS will begin to clearly understand the true nature of lease crude oil marketing as they begin to market barrels <u>at the lease</u> themselves. Conoco also believes that the MMS will not be successful in obtaining values as great as those they want to force on the industry in their new proposed rulemaking for all the reasons stated above. By taking federal royalty barrels in kind and marketing it themselves, the MMS will no doubt experience the true dynamics of lease crude oil marketing.

VI. <u>SUGGESTED ALTERNATIVE TO THE MMS PROPOSED RULEMAKING AND RIK PROGRAM</u>.

Conoco suggests that the MMS abandon its proposed rulemaking and in the alternative either take federal royalty oil in kind and market it themselves or allow the lessee to market the oil through a bid-out process <u>at the lease</u>. The MMS may be better off if they allow the lessee to market barrels via a bid-out process because in many instances lessees have the knowledge, experience and organization in place to obtain the best price <u>at the lease</u>. Also lessees are not burdened with restraints that preclude them from being active participants in market trades. Government regulations may restrict government employees in the level of participation in the marketing arena. Proper construction of such programs would accomplish the goals the MMS stated in the preamble to the notice of proposed rulemaking in the January 24, 1997 federal Register. The MMS could establish broad, but flexible, ground rules for lessees who would then develop a program to review with the MMS. The MMS would then review these lessee bid-out programs and approve those found to be reasonable. Approval would not be unreasonably withheld and a method of dispute resolution would be necessary. If any lessee bid-out programs were found to be unacceptable to the MMS, then the MMS should be required to take the royalty barrels in kind and perform the marketing function in whatever manner they choose.

VII. RULEMAKING PROCESS.

In deciding the appropriate process and procedure for seeking a new valuation rule, it is worthy to note that, since its inception in 1982, MMS has only once gone through the process of promulgating a regulation on oil valuation. Shortly after the MMS was created in 1982 by order of then Secretary James G. Watt, the MMS published a federal register notice on crude oil valuation. The federal register proposal was issued in November 1982, but no rule was ever forthcoming from that proposal. In late 1985 the Royalty Management Advisory Committee (RMAC) was formed to advise the Secretary on royalty matters. RMAC had its inaugural meeting in January, 1986. Soon after, the Oil Valuation Regulations Review Working Panel ("RMAC Oil Panel") was established to provide advice to the RMAC on the valuation of oil for royalty purposes. The RMAC Oil Panel, started in early 1986, held multiple hearings and numerous deliberations on crude oil valuation over a course of ten months. The recommendations of the RMAC Oil Panel were first submitted to the RMAC in July, 1986. This was during a time when oil valuation, as compared to gas, appeared simple and straight-forward. The final results were brought before the RMAC on October 20-22, 1986, for potential recommendation to the MMS. Despite the support at the Panel level, the RMAC never officially endorsed the RMAC Oil Panel Report. The 1988 crude oil valuation rule, which drew heavily on the RMAC Oil Panel, was published January 15, 1988 and made effective on March 1, 1988. During 1986-1988, the RMAC often held weekly meetings and briefings on the issue of product valuation. Even then, the process of review and analysis of data took some 24 months. In sum, since its inception in 1982, MMS has issued only one regulation on crude oil valuation and there was a period of six years after MMS's inception before that single regulation was promulgated. We do not believe MMS has given this new methodology the same intensive analysis.

VIII. PRODUCT VALUATION.

A. Historical Value for Royalty Purposes.

1. For arm's-length sales: "gross proceeds" - what the producer receives for production.

This is the current method of valuing production disposed under arm's length contracts. Gross proceeds for royalty valuation has been supported for, among others, the following reasons:

- For federal production, royalties have historically been due on gross proceeds.
- For federal lessees, gross proceeds represent the actual value received.
- For MMS, gross proceeds at or near the lease have always been the primary benchmark of market value under the regulations.
- The Interior Board of Land Appeals (IBLA) and the courts have long upheld gross proceeds in valuing production.

2. The U.S. Geological Survey Regulations of 1936 initiated the concept of gross proceeds.

The concept of valuation based on "gross proceeds" as a minimum value was first introduced in USGS's 1936 regulations.

The royalty computation regulation provided as follows:

> The value of production, for the purpose of computing royalty, in the discretion of the Secretary of the Department having jurisdiction over the leasehold, may be calculated on the basis of the highest price per barrel, thousand cubic feet, or gallon, paid or offered (whether such price is established on the bases prescribed in these regulations or otherwise) at the time of production in a fair and open market for the major portion of like-quality oil, gas, natural or casing-head gasoline, propane, butane, and all other hydrocarbon substances produced and sold from the field where the leased lands are situated; but under no conditions shall the value of any of said substances for the purpose of computing royalty be deemed to be less than the <u>gross proceeds</u> accruing to the lessee from the sale thereof or less than such reasonable minimum price as shall be determined by said Secretary. (Emphasis added.)

3. <u>The period 1942-1988</u>.

From 1942 until 1988, the regulations on the valuation of oil did not change materially and remained as published in 1942.

4. <u>The 1988 Regulations</u>.

In the article, "Evolution of Federal Royalty Management Regulation" by John L. Price, Principal Technical Advisor, Office of Enforcement, Royalty Management Program, Minerals Management Service, Denver, Colorado, reviewed by Milton K. Dial of the Minerals Management Service; James C. T. Hardwick, of Hall, Estill, Hardwick, Gable, Golden & Nelson, Tulsa, Oklahoma; and Geoffrey Heath, Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., it is noted as follows:

§ 6.04. The Regulations: 1988-Present.

The valuation regulations adopted in 1988 were based on the same foundations that the Department had laid through many decades of mineral royalty administration. The rate at which royalties were to be paid was that specified in the lease. The production on which royalty was due was production in marketable condition. Production that was unavoidably lost or used for operations on the lease was excluded from a royalty obligation. The value of the production on which royalty was due was to be the fair market value. For arm's-length transactions, the lessee's gross proceeds were generally accepted to be that value. (Price at 6-31) (Emphasis added).

By fiat, MMS has now abandoned this sixty-plus year old practice.

5. **Benchmarks for disposition under non-arm's length contracts**.

The 1988 regulations included five benchmarks for valuing oil not disposed of under an arm's-length contract. Unlike previous regulations, the benchmarks were to be applied in a predetermined order. The lessee had to apply the first benchmark or demonstrate that it did not apply before applying the second benchmark, and so forth.

The first benchmark was the lessee's own contemporaneous posted price or contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field or area. The lessee's posted prices, however, had to be comparable to other contemporaneous posted prices or contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field or area. The intent was that the lessee should be allowed to use its own posted price if it represented a reasonable value. The term "contemporaneous" was included to denote the price at the time the production was removed or sold from the lease, or at the time the royalty obligation was incurred. For oil sold by tank gauging, it generally meant the prices posted on the day the tank was run. In situations where oil was sold through an automatic custody transfer unit, it generally meant that the prices posted on each day of the month would be applied to the daily average volume of oil flowing through the meter for the month, provided that was the accepted manner under the sales contracts for the sale of oil from the field through such meters. In the latter case, the oil was viewed as being removed or sold from the lease, and thus the royalty obligation incurred, proportionately on each day of the month.

The second benchmark was the arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of like-quality oil in the same field, or area. The intent here was that if the lessee did not post, or if the lessee's posting did not "measure up," then those prices used by other parties representing fair market value should be used. The arithmetic average was chosen to eliminate the burden of ascertaining actual, monthly volumes of oil sold under each posted price.

The third benchmark was the arithmetic average of other contemporaneous arm's-length contract prices for transactions for like-quality oil in the same area or nearby areas. This benchmark would apply mainly to oil produced in remote fields for which no prices were posted.

The fourth benchmark included all factors that would be relevant in the event that there were no arm's-length prices on which to base value.

The last benchmark was a net-back method or any other reasonable method to determine value.

Even for sales not at arm's length, the value for royalty purposes could never be less than the lessee's gross proceeds, less applicable allowances.

B. MMS' 1997 Proposal.

1. The proposed regulations would create new valuation obligations which are arbitrary, capricious and unreasonable.

For the reasons stated herein, the proposed regulations are arbitrary, capricious and unreasonable.

For royalty purposes, value "means 'reasonable market value'; that price which a product will bring in an open market, between a willing seller and a willing buyer." United States v. General Petroleum Corp., 73 F. Supp. 225, 235 (S.D. Cal. 1947), aff'd sub nom. Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950). See also California Co. v. Udall, 296 U.S. 384, 387 (D.C. Cir. 1961) ("value" under Mineral Leasing Act means "fair market value"). Cf. NRDC v. Hodel, 865 F.2d 288, 312 (D.C. Cir. 1988) (approving Secretary's "willing buyer and willing seller" test for fair market value in the sale of leases); Amoco Production Co. v. Hodel, 877 F.2d 1243, 1245 (5th Cir. 1989), cert. denied, 493 U.S. 1002 (1989) (applying this fair market value test to oil and gas royalties).

Under the leasing statutes, it has long been settled that volumes of production are measured and valued at the wellhead on the lease. General Petroleum Corp., 73 F. Supp. at 254 ("royalties are payable on the gas as it is produced at the well"); Mobil Producing Texas & New Mexico, Inc., 115 IBLA 164, 171 (1990) ("normally gas is sold and valued for royalty purposes at the wellhead"). Even the Department's most attenuated method of valuing royalty, which values certain natural gas from Alaska's Kenai Peninsula by starting with the first sale's price in Japan and netting out the costs of transportation and liquefication, is nothing more than an attempt in a "special, unique situation" to "arrive at a reasonable wellhead value," Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1385 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S.

940 (1987). This measurement and valuation historically has occurred at the "point of royalty computation" located ordinarily "at the wellhead" or within the "lease ... boundary." (Conservation Division Manual, Part 647, chapter 1, p. 3.) Though the point is now denominated the "point of royalty settlement," 30 C.F.R. § 206.103(a)(1), its location remains unchanged. 43 C.F.R. § 3162.7-2 (onshore) and 30 C.F.R. § 250.180 (offshore).

2. <u>The proposed regulations would create new marketing obligations</u>.

MMS proposes to amend its product valuation regulations to provide that federal lessees are obligated to market oil at no cost to their federal lessor. <u>See</u> proposed § 206.102 (e), 62 F.R. 3753. Under existing regulations, federal lessees have an obligation "to market the production for the mutual benefit of the lessee and the lessor" and they have an obligation "to place [production] in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement." 30 CFR § 206.151. They do not, however, have an obligation <u>to market</u> production <u>at no cost</u> to their lessor.

MMS masks the creation of this new "marketing" obligation in two ways. First, MMS tries to equate the obligation to place production in marketable condition with the obligation to market. According to MMS, since the former must be done at no cost to the lessor, the latter must be done for free as well. The preamble to the proposed regulations states:

> Proposed paragraph (d) includes the same content as existing paragraph (e)(1), but is rewritten for clarity. We did modify the paragraph on your obligation to place oil in marketable condition at no cost to the Federal Government to clarify that it includes a duty to market the oil. This is consistent with several Interior Board of Land Appeals decisions construing this rule. See <u>Walter Oil and Gas Corporation</u>, 111 IBLA 260 (1989) (62 F.R. at 3746, 1/24/97).

The regulation states as follows:

§ 206.102 (e)

(e) What other general responsibilities do I have under this section? (1) You must place oil in marketable condition and market the oil for the mutual benefit of the lessee and the lessor at no cost to the Federal Government unless otherwise provided in the lease agreement or this section. If you establish value under this section as your gross proceeds, then you must increase value to the extent your gross proceeds are reduced because the purchaser, or any other person, provides certain services you normally would be responsible to perform to place the oil in marketable condition or to market the oil. (62 F.R. at 3746, 1/24/97).

It does not follow that all marketing costs must be borne by the lessee just because the costs of placing production in marketable condition are recognized as being the lessee's responsibility.

a. <u>The obligation to place production in marketable condition at no cost to the lessor cannot be expanded to encompass all marketing costs</u>.

The limited obligation to put production in marketable condition at no cost to the lessor has never before been equated with a broad, all encompassing obligation to market for free, at least not in the agency's duly promulgated regulations. MMS' current regulations, for example, define the phrase "marketable condition" as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 CFR § 206.151. Notably, this definition focuses on the <u>physical condition</u> that the production must be in so that it can be marketed under contracts typical for the field or area in which the production occurs.

Thus, under the current "marketable condition" regulation, the only thing that a lessee is required to do at no cost to the lessor is to place the production in the physical condition necessary to market it under contracts typical for the field or area. The cost of marketing efforts beyond placing the production in marketable condition at or near the lease is not even remotely contemplated by the marketable condition rule, either in its present form or as it has evolved throughout its history.

The obligation to put oil into marketable condition originally was found in two Department of the Interior regulations. The first provision, 30 CFR § 221.31, effective June 1, 1942, was originally published at 7 FR 4132, 4137. That provision, which governed federal onshore leases, stated:

> Emulsion and dehydration. The lessee shall complete and maintain his wells in such mechanical condition and operate them in such manner as to prevent, as far as possible, the formation of emulsion, or so-called B.S., and the infiltration of water. If the formation of emulsion, or B.S., or the infiltration of water, cannot be prevented or if all or any part of the product is unmarketable by reason thereof or on account of any impurity or foreign substance, the lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment or of costs of shipping. To avoid excessive losses from evaporation, oil shall not be heated to temperatures above the minimum required to put the oil into marketable condition. If excessive temperatures are required to break down any emulsion, then other means of dehydration must be utilized. Under such circumstances the supervisor must be consulted, and his approval obtained.

(Emphasis added.) This provision remained in effect until October 27, 1982, when part 221 was "revised and modernized." 47 FR 47758 (October 27, 1982). The revision and modernization process essentially removed the old 221.31. Then, on August 12, 1983, section 221.31 was redesignated as 43 CFR § 3162.25-3, 48 FR 36583 (August 12, 1983). Today it is found in 43 CFR § 3162.7-1(a), which provides: "The operator shall put into marketable condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land."

The offshore counterpart of this regulation was promulgated in 1954 as part of the regulations adopted to implement the Outer Continental Shelf Lands Act. As originally promulgated, the regulation provided:

> Emulsion and dehydration.
>
> (a) The lessee shall complete and maintain all oil wells in such mechanical condition and operate them in such manner as to prevent, so far as possible, the formation of emulsion and basic sediment.
>
> (b) The lessee shall put in marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment.

30 CFR § 250.41 (1954). This regulation, except for being redesignated as 30 CFR § 205.42 in 1968, remained largely unchanged until the late 1970's. Then, without explanation, in either the proposed rule, 44 FR 13527 (March 12, 1979), or the final rule, 44 FR 61892 (October 26, 1979), corrected, 45 FR 20465 (March 28, 1980), the provision was revised to read:

> The lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land. In calculating the royalty payment, the lessee may not deduct the cost of treatment.
> 30 CFR § 205.42 (1980).

In sum, there is no pre-existing regulatory support in the so-called "marketable condition" rule for imposing an obligation on federal lessees to provide free services over and above placing the crude oil in marketable condition.

b. The obligation to market for the mutual benefit of the lessor and lessee does not carry with it an obligation to market for the lessor for free.

Federal lessees have a regulatory obligation to market lease production for the mutual benefit of both parties. Nevertheless, this obligation to market for the mutual benefit of both itself and its lessor has never before been viewed as embodying the concept that this marketing must be done by the lessee for free.

While MMS purports to rely on pre-existing jurisprudential authority for its assertion that there is an obligation on the part of federal lessees to market lease production for free, the only authority it cites is a decision by the agency itself, i.e., the decision of the Interior Board of Land Appeals in Walter Oil and Gas Corp., 111 IBLA 265 (1989). Of course, the Department of Interior cannot create lease obligations by adjudication any more than it can by administrative fiat. Also, Walter Oil and Gas Corp. applied to gas, not oil.

Finally, the alleged existence of an obligation on the part of federal lessees to market lease production for free actually is inconsistent with the agency's duly promulgated regulations. Under the agency's published regulations, federal lessees are obligated to market lease production for the mutual benefit of both parties. See 30 CFR §§ 206.152(b)(1)(iii) and 206.153(b)(1)(iii). "Mutual" does not mean that one party gets a free ride while the other party bears all the expense.

c. **Federal lessees currently have an obligation to market only at or near the lease.**

The "marketable condition" rule requires lessees to put production in marketable condition for free. The "market" for which the production must be conditioned, however, is the market at or near the lease. See 30 CFR § 206.151 ("marketable condition" means lease products sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.) By changing the valuation methodology to reliance on NYMEX future prices or ANS spot prices, the market is no longer at the lease.

d. **MMS cannot, by regulation, impose a new obligation on federal lessees to market lease production for free.**

MMS' regulatory authority to determine the value of production on which royalties are due is limited by the governing statutes. Section 8(a) of the Outer Continental Shelf Lands Act requires the payment of royalty at a percentage "in amount or value of the production saved, removed, or sold from the lease." 43 USC § 1337(a). Likewise, the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of the production removed or sold from the lease." 30 USC § 226(b). Where the MMS has attempted to impose royalties on something other than the value of the production saved, removed or sold from the leased premises, the courts have declared the agency's action to be in excess of its statutory authority. See, e.g., Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988).

Under the proposed regulations here, MMS is attempting to impose royalties on the value of oil after it is removed from the leased premises. This is clearly beyond the agency's statutory authority, which is limited to valuing the production when it is saved, removed, or sold from the lease.

Even if the addition of a new obligation to pay royalty on the value of services provided by a lessee (or third parties) after federal lease production has been placed in marketable condition and after it has been removed from the leased premises is not precluded by statute, it is not contractually authorized. Under most federal leases, the Department of the Interior does not have the contractual authority to unilaterally amend the royalty payment obligations established in the lease.[1] Unless the lease expressly provides otherwise, the "property rights of the lessee are determined only by those rules in effect when the lease is executed." Union Oil Co. of California v. Morton, 512 F.2d 743, 748 (9th Cir. 1975); see

[1]Some federal leases provide that they are subject to all valid regulations promulgated by the Department of the Interior in the future. Many, however, do not.

Pauley Petroleum, Inc. v. United States, 591 F.2d 1308, 1325-26 (Ct. Cl. 1979), cert. denied, 444 U.S. 898 (1979). Moreover, the Fifth Amendment and fundamental due process also prohibit the United States from annulling previously created contractual rights. See, e.g., Perry v. United States, 294 U.S. 330, 353-54 (1935); United States Trust Co. of New York v. New Jersey, 431 U.S. 1, 26 n.25 (1977); National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co., 470 U.S. 451, 471 72 n.24 (1985).

Simply put, the value of crude oil for royalty purposes is the value at or near the lease.

C. The Proposed Rulemaking Is Premature in Requiring Payment of Royalties on Buydowns.

Proposed § 206.102(a)(5), 62 Fed. Reg. 3753, claims that a lessee's gross proceeds "include payments made to reduce or buy down the purchase price of oil to be produced in later periods." To the extent that the payments in question are to compensate the lessee for waiving rights under an existing contract, this position violates IPAA v. Babbitt, 92 F.3d 1248 (D.C. Cir. 1996).

The Department litigated the issue of buydowns, and it lost. The Court rejected the Department's arguments as to both buydowns and buyouts, finding them indistinguishable under the gross proceeds rule.

IX. PROCEDURAL REQUIREMENTS NOT SATISFIED.

A. The Regulatory Flexibility Act, Notice of Proposed Rulemaking, 62 Fed. Reg. at 3750 (1/24/97).

The Department certifies that this rule will not have significant economic effect on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C. § 601 *et seq.*). It would appear that the proposed rule will have such an impact. Under the proposal, the vast majority of federal lessees - even small companies who produce small quantities of crude oil, will be thrown into the category of a "non-arm's-length" seller of crude oil simply because they purchase one barrel of oil during a two-year period. Secondly, the proposal is a radical departure from both historic and current practice regarding the manner and method of determining royalty value at the well and for determining transportation costs which are deductible from royalty. Further, the Form 4415 proposed by the MMS is a part of a completely new scheme for MMS to not only require extensive data which must be manually collected and submitted, but also involves the wholly new process of MMS analyzing the data to determine what amounts will be deductible as allowed costs. While the transportation number derived by the MMS will have a substantial impact on any company's total royalty obligation for each lease, there is nothing contained in the MMS proposal to describe MMS's methodology for determining the number or requisite procedural safeguards to ensure the number is fairly and accurately ascertained.

B. Unfunded Mandates Reform Act of 1995, Notice of Proposed Rulemaking, 62 Fed. Reg. at 3750 (1/24/97).

The Department of the Interior has determined and certifies according to the Unfunded Mandates Reform Act, 2 U.S.C. § 1502 *et seq.*, that this rule will not impose a cost of $100 million or more in any given year on local, Tribal, or State governments, or the private sector. Conoco reserves the right to challenge this assertion pending review of governmental data.

C. Executive Order 12866, Notice of Proposed Rulemaking, 62 Fed. Reg. at 3750 (1/24/97).

The Office of Management and Budget has determined this rule is a significant rule under this Executive Order 12866 Section 3(f)(4) which states: "Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive Order." The Department's analysis of these proposed revisions to the oil valuation regulations indicate these changes will not have a significant economic effect, as defined by Section 3(f)(4) of this Executive Order. Again, under the proposal, the vast majority of federal lessees - even small companies who produce small quantities of crude oil will be thrown into the category of a "non-arm's-length" seller of crude oil simply because they purchase one barrel of oil during a two-year period. Secondly, the proposal is a radical departure from both historic and current practice regarding the manner and method of determining royalty value at the well and for determining transportation costs which are deductible from royalty. Further, the Form 4415 proposed by the MMS is a part of a completely new scheme for MMS to not only require extensive data which must be manually collected and submitted, but also involves the wholly new process of MMS analyzing the data to determine what amounts will be deductible as allowed costs. While the transportation number derived by the MMS will have a substantial impact on any company's total royalty obligation for each lease, there is nothing contained in the MMS proposal to describe MMS's methodology for determining the number or requisite procedural safeguards to ensure the number is fairly and accurately ascertained.

Conoco further adopts and incorporates by reference the Barents Report submitted to the Office of Management and Budget on March 25, 1997, on behalf of the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association and the Rocky Mountain Oil and Gas Association.

D. Paperwork Reduction Act, Notice of Proposed Rulemaking, 62 Fed. Reg. at 3750 (1/24/97).

This proposed rule requires a collection of extensive data which must be manually collected and submitted, and a wholly new process of analyzing the data to determine what amounts will be deductible as allowed costs. The new Form MMS-4415 is reported to require only 15 minutes to fill out. The MMS also states that their "subject matter experts" estimate that, on average, only "64 exchange agreements and sales contracts" will need to be reviewed to comply with these regulations. The MMS is obviously being misinformed by their "subject matter experts." Conoco has in excess of 900 contracts in force at any given point in time. Thousands of new contracts are written every year and under these new regulations Conoco would have to review each contract annually in an attempt to provide requested information, even those that do not have any connection to federal royalty oil. Therefore, thousands of MMS-4415 forms would be required of Conoco. These proposed rules would require that Conoco provide an MMS-4415 on an annual basis for "all your and your affiliates' crude oil production, and not just information related to Federal lease production." For the reasons stated under Section III, supra, MMS analysis under this Act lacks a factual or rational basis.

Conoco further adopts and incorporates by reference the Barents Report submitted to the Office of Management and Budget on March 25, 1997, on behalf of the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association and the Rocky Mountain Oil and Gas Association.

Conoco supports OMB's disapproval of MMS' application for collection of information as submitted. Specifically, OMB stated:

> In accordance with the Paperwork Reduction Act of 1995 and 5 CFR 1320.11, OMB raises the following concerns with this collection of information which require additional attention before resubmitting this collection prior to final rulemaking: The agency must clarify the instructions to the form to eliminate potential misunderstandings; The agency must consider further reducing the universe of respondents required to submit this information; and The agency must further detail how this information will be used to calculate the location differentials required in this rulemaking.

E. Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. 104-126, 110 Stat. 857 (3/29/96).

Under § 251, the law requires federal agencies to submit a report to each House of Congress and to the Comptroller General of the United States before a rule can take effect. Pending review of these reports, Conoco withholds comment.

X. THE MMS PROPOSAL FAILS TO DISCLOSE CENTRALLY RELEVANT INFORMATION.

The proposed rulemaking contemplates a valuation methodology which is not only complex but represents a radical change from well-established crude oil valuation practices woven deeply into the MMS' existing regulations.

The preamble to the proposed rulemaking states:

> MMS used various sources of information to develop the proposed rule. In addition to comments received on the Advance Notice of Proposed Rulemaking, MMS attended a number of presentations by: crude oil brokers and refiners, commercial, oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. MMS' deliberations were greatly aided by a wide range of expert advice.[2]

Given the complexity of the Proposal and its radical departure from the MMS' existing regulations, many unexplained assumptions and conclusions deprive the rulemaking stakeholders of a meaningful opportunity to review the Proposal. In an attempt to close this information gap, API and other associations filed a February 28, 1997, Freedom of Information Act request. Specifically, the FOIA-related information released to date, while relevant, is plainly incomplete, carries no explanation of its linkage to the Proposal, and has only become available toward the end of the public comment period. As a result, the Proposal does not satisfy well-established principles for notice under the Administrative Procedure Act (APA).

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[2]Proposal at 3742.

In Home Box Office, Inc. v. FCC, the D.C. Circuit observed that ". . .the notice required by the APA, or information subsequently supplied to the public, must disclose in detail the thinking that has animated the form of a proposed rule and the data upon which that rule is base."[3] "An agency proposing informal rulemaking has an obligation to make its views known to the public in a concrete and focused form so as to make criticism or formulation of alternatives possible."[4]

In Connecticut Light and Power Co. v. NRC, the D.C. Circuit added:

> If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals. . . . In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that has been employed in reaching the decisions to propose particular rules. To allow an agency to play hunt the peanut with technical information, hiding or disguising the information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport.[5]

Citing Home Box Office and Connecticut Power & Light, Florida Power & Light Co. v. U.S. states "notice must not only give adequate time for comments, but also provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully."[6]

To satisfy the minimum due process requirements of the Administrative Procedure Act, the MMS must do something which offers stakeholders more information and more time. At the very least, the MMS should extend the comment period for a reasonable period beyond the time of receipt of materials provided under the Freedom of Information Act request.

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[3]Home Box Office, Inc. v. FCC, 567 .2d 9, 35 (D.C. Cir. 1977).

[4]Id. At 35.

[5]Connecticut Light and Power Co. v. NRD, 673 F. 2d 525,530 (D.C. Cir.)

[6]Florida Power & Light Co. V. U.S. (D.C. Cir. 1988).

XI. THE MMS PROPOSAL OFFERS NO BASIS FOR SHORTCIRCUITING INFORMAL RULEMAKING PROCEDURES THROUGH USE OF AN INTERIM FINAL RULE.

The preamble states that:

> MMS may publish an Interim Final Rule while it further evaluates the methodology in this proposed rule. This approach would provide the flexibility to do a revision after the first year without a new rulemaking.[7]

If ever there was a rulemaking unsuitable for the shortcircuiting of informal rulemaking procedures through publication of an interim final rule, it is this rulemaking. The APA does state that the prescribed minimum requirements of notice-and-comment rulemaking procedures do not apply:

> (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
>
> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.[8]

Of the two kinds of exceptions, it seems evident that only the "good cause" exception is even potentially applicable to the present rulemaking and while the MMS at this juncture has offered no legal justification whatsoever for such a shortcut, some well-established APA principles are noteworthy.

First, myriad federal court decisions make it clear, as a general matter, that the statutory exceptions to the APA informal rulemaking requirements should be narrowly construed. The "good cause" exception is no different.

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[7]Proposal at 3743.

[8]APA sec. 553(b)(3); 5 USC sec. 553(b)(3).

Nothing suggests that, for the crude oil valuation rule here, normal rulemaking would be "impracticable," "unnecessary," or "contrary to the public interest." In sum, the MMS should abandon any further consideration of an interim final rule for the complex, radical change in crude oil valuation methodology reflected in the Proposal.

XII. MMS' FORMULA TO DETERMINE ROYALTY VALUE AT THE LEASE IS FATALLY FLAWED.

Section 206.102(c) establishes value under the MMS formula and Section 206.105(c) establishes the deductions under the formula. The following paragraphs explain why the formula is flawed, so flawed that it is completely unusable to determine value at the lease.

A. MMS is proposing to use the NYMEX futures price as their base value. That value would be adjusted by the difference between the published spot market values at a market center and the NYMEX value.

Our comments have previously stated why we do not believe NYMEX is an appropriate value. We would only add here that it is amazing that MMS would define a paper market as the market value of crude oil while totally ignoring the lease market where thousands of physical barrels are sold daily.

We also do not believe that the adjustment based upon the spot market price at the market center is appropriate. The published spot market price represents a value for an incremental barrel into a refinery. In other words, it represents a value a refiner was willing to pay for small volumes to fill his refinery capacity. It does not represent a value a refiner would be willing to pay for his total refinery capacity.

Also, MMS states in the preamble that when you do not move oil through an MMS identified market center, you would need to use the market center nearest the lease where there is a published spot price. In their example, they state that West Texas Sour and Wyoming Sour would be like-quality. This is a ridiculous statement. West Texas Sour is approximately a 34 degree API gravity, 1 percent sulphur crude oil. Wyoming Sour is approximately a 25 degree API gravity, 2.5 percent sulphur crude oil. They are only like quality in that they have the word sour in their name.

B. MMS proposes to allow a quality/location differential between the market center and the aggregation point. This differential may be either a specific differential between the two points specified in the exchange agreement or a number published by MMS based upon data collected on MMS Form 4415.

First of all, a differential in an exchange agreement is simply a trading difference. It may involve quality differences, location differences, or both, or there may not be a differential. What a differential is not intended to do is to measure the cost to move crude oil from an aggregation point to a market center. Use of a differential which does not account for the cost of movement is not appropriate for determining value at the lease. Also, MMS seems to assume that we can trace crude oil. This assumption is totally incorrect. The only time a producer could deduct a specific difference is when the crude oil is contractually identified, because we certainly would not be able to use it otherwise.

Second, there is nothing sinister about an exchange agreement as MMS would have people believe from the tone of the proposed rule. Exchange agreements are used to get crude oil from where you have it, to where you need it, or to trade crude oil you have for crude oil you need. By way of example, assume a producer had crude oil in Wyoming, but it needed it at its refinery in Louisiana. It is physically impossible to get the crude oil between those two points in a cost justified manner. An exchange is the solution to that problem.

Third, we question the validity of data gathered on MMS Form 4415. MMS is going to be collecting duplicate data, incomplete data, and in some cases, no data. From that hodge-podge of data, they are going to publish differentials that the producers must use even though the data is out of date when published and we have no right to determine how or what MMS did with the data they received. That is a totally unworkable situation. In fact, this will cause significantly greater problems than the major portion analysis currently done by MMS.

C. <u>MMS proposes to allow the lessee to deduct his actual transportation cost from the lease to the aggregation point</u>.

For the majority of producers, Conoco included, this is not a cost that we know nor is it a cost we can readily determine. For onshore leases, if we built a pipeline from the lease to the pipeline interconnect we have not tracked those costs because we valued the crude oil at the lease. It would be virtually impossible to calculate those costs today. If we are selling at the wellhead and the purchaser does not deduct transportation, then we have no actual transportation costs. What MMS has done is to move the valuation downstream of the royalty determination point as determined by BLM without any form of cost deduction. One, we question the fairness of that move, but more importantly, we question the legality of it. MMS cannot arbitrarily move the valuation downstream.

D. <u>MMS' proposal fails to allow any form of gravity deduction for the lease gravity</u>.

MMS has accounted for gravity differences between the aggregation and the market center but has not allowed for any adjustment between the lease and the aggregation point.

E. <u>Summary</u>.

MMS' formula is so flawed that it is totally unusable to determine value at the lease. MMS needs to go back to the drawing board and propose a rule that recognizes the very competitive lease market that exists today and will continue to exist. Also, they need to propose a rule that recognizes valid arm's-length contracts as a basis for determining royalty value for both arm's-length and non arm's-length transactions. See Conoco's bid-out proposal at VI, page 10.

XIII. FERC TARIFFS.

A. The preamble states that the use of a FERC approved tariff is no longer a viable alternative with respect to oil pipelines located on the OCS.

We believe that MMS has removed this exception prematurely. There is an extensive administrative appeal on this issue that has yet to be decided. Until there is a final decision on this issue, FERC tariffs should remain a viable exception.

XIV. ROYALTY SIMPLIFICATION AND FAIRNESS ACT ISSUES.

A. Credits.

Section 206.102(e)(2) states "If you are entitled to a credit, MMS will provide instructions for taking that credit". We are not sure what situation this sentence is referring to. The Royalty Simplification and Fairness Act ("RSFA") provides the mechanisms for either taking a recoupment or filing for a refund. MMS needs to clarify this paragraph.

B. Limitations.

Section 206.102(g) states "... closing of the audit period does not foreclose MMS from correcting the error and collecting any royalties due". This sentence needs to be clarified. Under provisions of RSFA, if the lessee has been notified that a time period is closed to further audit, that action tolls the limitations period and MMS is barred from correcting the error. This sentence needs to be rewritten to comply with the provisions of RSFA.

C. Calculation of Differentials.

Section 206.105(c)(4)(iii) states that if you do not file a request for a MMS calculated differential, MMS will not refund any overpayments you made due to your failure to timely request MMS to calculate a differential. This penalty is extremely harsh and is akin to the old allowance payback penalties. We can think of at least two situations where the lessee may not know within 30 days after MMS publishes its annual listing if it needs to request a MMS differential: (1) new wells on a previously non-producing lease and (2) acquisitions of new properties. Also, because refunding overpayments is an obligation of the Secretary under provisions of RFSA, we question the legality of this penalty. We urge MMS to reconsider this statement.

CONCLUSION.

Conoco opposes the new proposed valuation methodology.

Neither the rulemaking notice nor the related documentation from the rulemaking record (which MMS has released under the Freedom of Information Act) supports the need for an amendment to the current regulations. It appears from that record that MMS has adopted a set of assumptions about oil markets from consultants whose primary business is to aid the plaintiffs' bar in conducting litigation against producers of oil and natural gas. These assumptions have not been tested by any empirical study, have not been made as a result of MMS's own auditing program, and have not even been the subject of any peer-reviewed academic paper in the field of economics. They have, however, been preliminarily examined in litigation. In Engwall v. Amerada Hess, No. CV-95-322 (5th Jud. Dist. N.M.), the court refused to certify a class action proposed by plaintiff-lessors, based on the theory that valuation should begin with prices for oil traded in Cushing, Oklahoma, then adjusted back to leases in New Mexico. It stated the "various claims asserted by plaintiffs ... are novel in the sense that plaintiffs have not cited to the Court previous precedent from any jurisdiction which has accepted plaintiffs' legal theories with regard to the royalty and overriding royalty obligation..." Id., Decision at 2 (March 26, 1997). MMS has failed to lay the foundation for the dramatic change it seeks to impose.

If, however, the Department of the Interior determines that it will alter the current rules, Conoco offers two alternatives which more rationally address the concerns identified in the rulemaking notice. The first alternative is for the Department to exercise its right to take its royalty share in kind. As a guidepost, the Department need only look to the royalty in kind program run by the Province of Alberta, Canada, or that run by the State of Texas.

The second alternative is for the Department to accept that there is, and has long been, a vibrant market for crude oil at the wellhead, field, or (for some OCS leases) first onshore terminal. The sales transactions occurring at these points offer the best evidence of the value of royalty oil at the wellhead. A bid-out program by the lessee <u>at the lease</u> is an option that should be allowed for valuing crude oil.

Conoco believes the advantages of such an alternative are:

- Keeps lease value at the lease
- Captures values of willing buyers for outright purchases
- Easy to audit
- May garner prices higher than proposed new rulemaking
- Reduces paperwork of both the MMS and the industry (versus proposed new rulemaking)
- Is fair to both the MMS and the lessee

The goal of the bid-out program is to obtain a fair representative value for crude oil and condensate at the lease. We firmly believe this program does just that. We also think the MMS could develop an alternative such as Conoco's program that could be used by those in the industry for federal royalty oil who are concerned with various aspects of the existing MMS rules or the proposed new rulemaking. Conoco would be pleased to offer its assistance to the MMS in developing such an alternative.

This bid-out alternative, although new to Conoco, has been utilized by marketers of royalty crude oil some of whom are in the same position and hold similar royalty interests as the MMS, including the University of Texas System and the Wyoming State Land and Farm Loan office. Conoco strongly recommends that the MMS provide lessees the option of such a bid-out program. Conoco also recommends that the MMS strongly considers, under such programs, allowing the lessee to market the federal royalty oil/condensate because in many instances the lessee is already performing this function and will likely get a better price versus the MMS marketing it themselves.

There is no need or justification for abandoning the 60 plus year old method of valuing crude oil at the lease.